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Report on criteria for the determination of project-specific cost recovery rates*

Summary

This report is the third in a series that elaborates the UNDP cost recovery system. Complementing previous reports, it should be analyzed in their context. The present report establishes how the recovery rate for general management support (GMS) for a specific project is determined, based on the criteria of full cost recovery above the base structure and of proportional sharing of indirect cost among all sources of funds.

The criteria for the determination of the GMS rate within the prescribed range of 5 to 7 per cent should not be an abstract set of rules but must be based on the actual operational environment of the project, and should take into account differences in the nature and complexity of projects, and differences in costs among offices. The GMS rate of 5 to 7 per cent was set at the corporate level based on an aggregate calculation of UNDP indirect variable costs, and the required proportional contribution of Other Resources to UNDP total operational costs. This approach is consistent with the harmonized principles and methodology of cost recovery agreed on among United Nations organizations.

This policy is also closely linked to the UNDP 2004-2005 budget strategy laid out in document DP/2003/28, which is built on the principle that Regular Resources pay for the base structure (fixed cost) for country offices and headquarters. Above the base structure, the principle of equal burden-sharing between Regular and Other Resources will be gradually implemented. This means that each source of fund is expected to pay for its proportional share of UNDP operational costs. The income generated from cost recovery represents the contribution of Other Resources to the biennial support budget.

* The need for additional analysis has delayed submission of the present document.

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In view of the decentralized nature of UNDP with regard to (a) Other Resources mobilization, (b) projects/programmes management, and (c) local country office cost structures, UNDP provides flexibility, within the prescribed range of 5 to 7 per cent, to country office management to decide on the final rate of cost recovery, taking into account the key principles and parameters mentioned above. This flexibility allows country offices to charge, when justified and negotiated with the funding partner, a GMS rate above 7 per cent.

During the first year of full implementation of its new cost recovery policy, UNDP will vigorously monitor compliance, and will present the results – together with any proposals for change – to the Executive Board in 2007.

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I. Background

1. In the last 12 months, UNDP has prepared three reports – this being the last – in response to requests by the Executive Board to provide more information on the management of cost recovery. The three reports present a comprehensive picture of cost recovery from three different viewpoints.

2. The *first*, UNDP strategic cost management and its implications for cost recovery (DP/2004/35), explored the classification of direct and indirect cost in the context of United Nations simplification and harmonization efforts. Based on this classification, a high-level analysis was presented recommending that indirect cost be recovered in the form of general management support (GMS) from all trust fund and third-party cost-sharing projects in the range of 5 to 7 per cent, and from programme country cost-sharing projects averaging 3 per cent for the country project portfolio.

3. The *second*, reporting of UNDP income from cost recovery (DP/2005/CRP.4), provided details on the utilization of income generated from cost recovery, and suggested improvements in the way income is reported as part of the biennial support budget in order to increase transparency.

4. This *third* and present report elaborates on project-level cost recovery and is in response to Board decision 2004/30 requesting clear criteria to determine GMS for a specific project and to encourage donor incentives for unearmarked fund contributions.

5. In order to set criteria for the proper recovery of GMS, it is necessary to understand:

(a) UNDP funding in a decentralized, multi-funded environment; and

(b) How costs are managed at the project level, including an overview of project management in UNDP.

6. It is also important to recognize that 2005 is the first year of full implementation of the new cost recovery policy. UNDP will monitor the implementation of the policy, review internal processes and take corrective actions. How far the range of 5 to 7 per cent in GMS will have achieved proportionate funding from all resources will be reported to the Executive Board in 2007, together with any proposals for adjustment to the policy.

II. UNDP funding in a multi-funded environment and its implications on cost recovery in UNDP

7. UNDP has evolved into a multi-funded organization whose funding strategy has shifted from a centralized approach focused on Regular Resources to a dual-pronged strategy. Under this strategy, unearmarked Regular Resources are mobilized at the global level while tied Other Resources are mobilized corporately as well as specifically for country programmes and individual projects.

8. Key UNDP donors have also shifted decision-making on Other Resources funding to the local level. This in turn has required concerted efforts to provide more

structure and guidance to units in mobilizing Other Resources, including the establishment of a clear cost recovery framework. At the global level, for example, the Framework Agreement between the United Nations and the European Commission spearheaded a common approach to cost definitions and indirect cost rates, which covered the majority of United Nations entities. Likewise, UNDP has negotiated global agreements with individual donors that include provisions for the recovery of GMS.

III. Managing cost at the project level

9. In UNDP, all development interventions are undertaken in the framework of a project.[1] The project serves as a tool to track costs, in the form of human and financial resources, against a set of results in the form of outputs and outcomes. Both the tracking of results and costs is essential for the proper monitoring and evaluation of the project. Moreover, it also enables the results-based allocation of resources in such a way that development outcomes are maximized.

10. The project budget is the monetary expression of all the efforts necessary to achieve the objective of the project. Theoretically, it is possible to determine exactly all inputs necessary for the achievement of a project's objective, and to budget for them as direct cost. Certain inputs, however, might only be required on a partial basis and could be shared among a number of projects. Sometimes, however, it is not practical or even desirable to track all cost directly against a project.[2]

11. Consequently, at the time a project is formulated with stakeholders, there are two classes of indirect costs that need to be factored in by the responsible unit:

(a) *Costs that are attributed indirectly to the project* because they represent functions that take place before or after the project is operational (e.g., project design, financial reporting) or that cannot practically be linked to individual projects (e.g. oversight, knowledge, systems). Most of these costs originate outside the unit that is designing the project, particularly at the headquarters or central level, and are therefore unknown to individual units.

(b) *Indirect costs that are a reflection of the specific project* and the choices made as part of the project design (e.g., management arrangements, project location, size and complexity, donor requirements). These costs are a reflection of the specific situation in which a concrete project is managed; only the individual unit designing the project can determine them.

12. The overarching criterion guiding the determination of the project-specific overhead rate is *the recovery of cost attributable to the project*. Therefore, the rate for the recovery of indirect cost, as per UNDP cost recovery policy, is established based on the total setup cost necessary for the effective management of a portfolio of projects, taking into consideration indirect costs incurred at the programme country level, as well as at the central or headquarters level. In other words, the

[1] In this context, the concept of a project relates to a management tool and is distinct from the UNDP programme approach for development. All development programmes and projects and all management activities are undertaken in the framework of a project based on project cycle management standards.

[2] For a more detailed discussion of direct and indirect costs, please refer to document DP/2004/30, UNDP strategic cost management and its implications for cost recovery.

criterion in setting up the project-specific rate is the recovery of all indirect cost in such a way that they are proportionally split among all sources of funds.

IV. Criteria for determining specific cost recovery rates

13. In determining the current GMS range of 5 to 7 per cent, UNDP analyzed at the corporate level both the expenditure patterns for Regular and Other Resources and the management, setup and programme support cost necessary to sustain development programmes properly.[3]

14. At the same time, UNDP will be revisiting the proper delineation between programme cost and management cost. It is expected that the increase in GMS and the improved classification of cost will substantially reduce the funding gap from Other Resources by the time that UNDP reports back on the implementation of the new policy in September 2007, in line with Board decision 2004/30.

15. At the country level, giving offices a range of 5 to 7 per cent for total GMS provides them a certain degree of flexibility to adjust the rate based on the design and management decisions made for the specific project (types of activities, complexity, specific requirements or volume). This type of approach also allows for differences in the cost of operations among different offices, for example, in the cost of personnel and operations. However, that does not mean that units can set GMS rates at random. The stated goal of the Executive Board is to ensure that Other Resources pay the fair share of all costs related to the delivery of development programmes.

16. UNDP has established a fixed floor of 2 per cent in GMS for every trust fund project and third-party cost-sharing project that is used to cover the indirect costs of central and headquarters units. Establishing this fixed floor guarantees that units negotiating the funding of a specific project do not overlook indirect costs that originate outside their own unit. Therefore, if an office agrees with a donor on a GMS rate of 7 per cent, 2 per cent will be used to cover central or headquarters indirect cost, while 5 per cent will be used to cover indirect cost at the office level.

17. Establishing more detailed criteria – going beyond just the full recovery of cost above the base structure cost at the unit level – might seem a logical step to providing further guidance to offices. However, it would almost be impossible to legislate criteria for the determination of a specific rate based on project parameters, and in fact such global criteria would run the risk of either grossly oversimplifying or inadequately capturing the cost of a specific project's management arrangements. For example, establishing a rate criteria based on a specific resource volume (i.e., 5 per cent for all contributions over $1 million) by no means would guarantee that the right amount of recovery takes place, as there is no link back to the management effort needed. While at the global level it is fair to assume that the management effort is the same for Regular and Other Resources, and that therefore management and programme support costs should be shared proportionally, this is not necessarily true on a project-by-project basis. In order to account for the differences in projects, some flexibility in setting individual rates is necessary, even if these differences in the aggregate cancel each other out.

[3] DP/2004/35 on strategic cost management provides detailed information on calculation of aggregate cost recovery rate.

18. In line with the base structure concept, which is considered a fixed cost in the context of the harmonized cost definition, UNDP assessed the most appropriate option for the recovery of variable indirect costs, which should be covered by each fund source. In line with this principle, the GMS has been set at a range of 5 to 7 per cent as a gradual move to full proportionality above the base structure.[4] The same concept will apply for the 2006-2007 biennial support budget. The income from cost recovery through GMS will represent the level of contribution of Other Resources to UNDP indirect variable costs.

19. In sum, UNDP recommends that the main criteria to guide the determination of a specific GMS rate – above the 2 per cent fixed rate for central or headquarters indirect costs – should be the proportional sharing of all indirect costs among Regular and Other Resources at the individual unit level. This approach ensures that the Board requirement for the elimination of any subsidy from Regular Resources is fulfilled while at the same time preserving a minimum of flexibility to adjust the GMS rate based on the specifics of the project in question.

V. Incentives for increased untied contributions

20. Regular Resources are the funding bedrock of UNDP. Like most other United Nations organizations, UNDP is not only delivering projects but also plays a critical role in advocacy and knowledge-sharing. In particular, the organization's role as funder and manager of the resident coordinator system, entrusted to UNDP by Member States, requires funding that is independent from the delivery of development programmes. It is appropriate, therefore, for the organization to emphasize the mobilization of untied Regular Resources.

21. UNDP also recognizes that there are many factors external to the organization that influence donor decisions to contribute resources. Setting financial incentives, therefore, might not achieve the desired outcome of increased Other Resources contributions. Instead, the organization must ensure that each source of funds covers its proportional share of management and programme support costs. Donors also have preferences for certain project outcomes, and UNDP efforts to establish results-based management throughout the organization will enable donors to see and appreciate better the achievements attained by projects while at the same time disclosing the cost of managing them.

22. In conclusion, UNDP recommends that the incentives to donors to contribute both Regular and Other Resources to UNDP should be built on: (a) the focus of the intervention in line with the multi-year funding framework priorities; (b) alignment to the programming cycle; and (c) the development results that each pool of funding achieves, as long as the attributable costs of management are proportionally split.

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[4] Details of calculation of GMS at the aggregate level are provided in DP/2004/35 on strategic cost management, Annex V, B-calculation of the cost recovery rate.